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C O N F I D E N T I A L SECTION 01 OF 02 SOFIA 000679

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TAGS: ECON EFIN PGOB BU
SUBJECT: FISCAL DISCIPLINE KEEPS FINANCIAL CRISIS AT BAY,
BUT BULGARIAN-OWNED BANKS ARE WEAK LINK

Classified By: Ambassador Nancy McEldowney for reasons 1.5 (b) and (d).

¶1. (C) Summary: The Bulgarian financial system's relative lack of sophistication, along with the Government's policy of fiscal discipline, are insulating the country from the current international financial crisis. The global credit crunch will have an impact on the real economy, in terms of reduced FDI, access to credit, and lower growth, but these could also serve to mitigate Bulgaria's two key imbalances: the current account deficit and inflation. Bulgaria's largely foreign-owned banking sector is well-capitalized and strong, but the Bulgarian-owned segment of this sector is the dark cloud on the economic horizon. Turbulence in the banking sector, if it appears, will not be a direct result of the international financial crisis -- it will be home-grown. End Summary.

¶2. (C) Foreign and domestic analysts, including from the EBRD, Central Bank, Ministry of Finance and leading banks are expressing confidence that Bulgaria will emerge from the current international financial crisis with lower growth, but otherwise largely unscathed. Citing the Bulgarian financial system's relative lack of sophistication ("we don't use derivatives here"), Minister of Finance Plamen Oresharski told us the Bulgarian banking sector is well-insulated from the current crisis. In addition, the Socialist-run government has been pursuing a policy of strict fiscal discipline, running surpluses of one to three percent for the past five years. These surpluses have been accumulating in a fiscal reserve now totaling more than 10 billion leva (6.7 billion USD). This prudent fiscal policy will continue, as leaders from across the political spectrum agree that it is needed as a hedge against external shocks that might put pressure on the country's currency board, now it its 11th year.

¶3. (C) The growth rates Bulgaria has enjoyed for the past seven years will undoubtedly take a hit. This growth has been fueled by robust domestic demand and supported by easy credit and strong foreign direct investment (plus speculative bursts in an overheated property market, now ready for contraction.) With the global financial crisis, FDI has already slowed (preliminary data shows FDI down 12 percent in the first eight months of 2008) and access to bank credit is tightening. As a result, the Ministry of Economy reduced its 2009 GDP estimate to between 4.7 to 5.5 percent compared to 2008's estimated 6.5 percent growth. Our financial interlocutors point out that the upside to this slowdown is an eventual expected decrease in the high current account deficit (21.5 percent of GDP in 2007) and a projected lowering of inflation. At 11.6 percent in 2007, inflation is the only indicator preventing Bulgaria from joining ERM-II.

¶4. (C) The foreign-owned segment of the Bulgarian banking sector is strong. Nine of the top ten banks in Bulgaria are foreign-owned, and bankers have said money is still flowing from European parent banks but the cost of lending is higher.

The Bulgarian National Bank, which operates a currency board, has few levers at its discretion to inject liquidity into the market. It has already decided to increase deposit guarantees to 50,000 Euro (up from 20,000 Euro). Reluctant to decrease reserve requirements directly, the Central Bank has started to allow banks to count 50 percent of bank cash deposits held at the Central Bank into the basis upon which the deposit reserve requirement (currently 12 percent) is calculated. This measure is good for 90 days, but it may be extended.

¶5. (C) Comment: While Bulgaria's relative lack of sophistication does insulate it somewhat from the current financial turbulence and fiscal discipline is serving the country well, there is a dark cloud on the horizon. Large foreign investors who depend on syndicated loans say credit is tightening dramatically across Europe. This will delay large infrastructure projects in Bulgaria. The U.S. energy giant AES, the largest foreign investor in Bulgaria, says it does not expect to be able to raise credit for several major Bulgarian projects for the next 11 months. In addition, the Bulgarian-owned bank First Investment, the sixth largest bank in the country with a major retail presence, experienced a mini-run in May after liquidity rumors spread on the internet. On September 23, the global credit rating agency Fitch revised its outlook on First Investment to negative, citing the current market environment. Smaller Bulgarian-owned banks may also be at risk. Several appear to be boutique entities created only to finance and launder projects of various Bulgarian oligarchs and well-connected businessmen. With lax anti-money laundering oversight on the part of the Central Bank and other financial supervision

entities, Bulgaria may find that it survives the current international financial crisis, only to fall victim to home-grown banking instability.
McEldowney